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SUBJECT: EU/UKRAINE/RUSSIA: LIVING UP TO THE AGREEMENT

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¶1. (SBU) Summary. On January 14 the EU Commission's point person on monitors for the Ukraine/Russia gas crisis, Director for Security of Supply and Energy Markets Heinz Hilbrecht, described the events leading up the current crisis and highlighted the challenges ahead. Hilbrecht believes there are currently three main sticking points to the negotiations: Russian gas flows and points of entry; access for Russian monitors; and who will bear the costs of technical gas. The Commission is working to convince the Russians that unilateral decisions on how much gas and where to inject it are not helpful. There needs to be coordination at the technical level between Gazprom and Naftogaz to decide where the gas should be input, at what volumes, and where it should exit. A second problem revolves around Ukraine's refusal to grant access to Russian monitors as stipulated in Monday's agreement. Ukraine, apparently in hindsight, is concerned over sharing data on domestic use and storage levels with Russia. The third issue concerns the technical gas to fuel the compressors, which we understand Ukraine is obliged to provide under the terms of the current RUS-UKR transit agreement (which lasts until 2013). Normally, Ukraine would use its own gas, which it receives at a discounted price from Russia. However, since the Russia-Ukraine supply agreement has expired, Ukraine is no longer receiving gas at a discounted price. End Summary.

#### Evolution of the Crisis

¶2. (SBU) Hilbrecht said that the current crisis grew out of Russia and Ukraine's inability to agree on the price Ukraine should pay for its domestic gas needs. Intertwined with the domestic price is the cost to Ukraine of supplying the "technical gas" needed to run the transit system which, according to the existing transit agreement, Ukraine is required to supply out of its domestic supply. The two sides had reached an agreement with a price of \$250 per thousand cubic meters (mcm) with a phased increase over time to bring the Ukrainian domestic price up to market prices. This deal fell apart, however, when Ukraine backed out over the price issue at the end of the year. (Note: Hilbrecht reiterated that the EU does not want to take a position on what the price should be. End Note.)

¶3. (SBU) This situation led to Russia's decision to cutoff gas for the Ukrainian market on January 1. This was followed by Russia's decision to cut off all gas flows to Ukraine, and by consequence its European customers, when it accused Ukraine of stealing gas from the flow intended for Europe. The situation continued to deteriorate until the EU managed to broker a deal whereby EU monitors would be sent to the entrance and exit points of the Ukrainian gas system to verify that the amounts of gas entering Ukraine comported with those exiting Ukraine to Europe. This agreement was signed by Russia, Ukraine, and the EU, but had to signed

again after Russia objected to a handwritten attachment annexed by Ukrainian PM Tymoshenko.

14. (SBU) A team of 18 monitors recruited from the European gas industry along with four Commission representatives were deployed to Russia and Ukraine over the weekend. After a few hiccups, the EU monitors were granted access to the entry and exit points as well as the dispatching centers in Moscow and Kyiv. The trilateral agreement also called for Russian and Ukrainian monitors to be deployed to these same sites. Ukraine has so far, however, denied Russian access to its dispatching center. Russia claims it needs access there to be able to assess how the gas is flowing and where it is being used. Hilbrecht believes the Ukrainians are denying access because they don't want the Russians to gain access to information on their storage levels.

15. (SBU) On Tuesday morning, Russia started supplying gas into the Ukrainian system at the Sudzha entry point in northern Ukraine at a rate of 76 million cubic meters per day (mmcm/d) with the expectation that it would transit Ukraine and arrive at the Orlovka exit point on the southern border with Romania. Hilbrecht explained, however, that this was not technically feasible. After the Russian shut-off Ukraine has reversed the flow of some of the East to West pipelines and has been pumping gas from storage facilities in the West to meet domestic demands in the East. He described Ukraine's gas system as a mesh and said that with high volumes flowing West to East, there was no way to pump gas at low volumes crossing the West to East flow to transit gas from the North to the South. When the gas did not reach Orlovka, Russia once again shut off the gas.

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16. (SBU) Today Russia has once again agreed to start pumping gas, but only at a volume of 100 mmcm/d with approximately 80 mmcm/d going in at Sudzha and 20 mmcm/d going in at the Valuvki entry point, also in north eastern Ukraine. Hilbrecht was doubtful that this gas volume would be sufficient to allow gas to transit to Orlovka. The Ukrainians have claimed that they need at least 120 mmcm/d to restart the flow. Hilbrecht said that from the EU's perspective Gazprom has a contractual obligation to deliver gas to its European customers. As such, Gazprom should step up and be willing to provide the technical gas if it is necessary to ensure the contracted gas arrives at its destination. Otherwise, Gazprom will be in default of its contracts with EU Member States.

#### Sticking Points

17. (SBU) Hilbrecht believes there are currently three main sticking points to the negotiations: Russian gas flows and points of entry; access for Russian monitors; and who will bear the costs of technical gas. The Commission is working to convince the Russians that unilateral decisions on how much gas and where to inject it are not helpful. There needs to be coordination at the technical level between Gazprom and Naftogaz to decide where the gas should be input, at what volumes, and where it should exit. Hilbrecht said the Ukrainians had proposed a technical coordination agreement to cover a three month period, but the Russians have so far rejected this. Hilbrecht believes that a more medium term agreement is needed on the technical aspects of shipping gas and that they can continue on an ad hoc basis.

18. (SBU) EU officials believe that under the terms of Monday's monitoring agreement, Ukraine must provide access to the Russian monitors. They advised that Ukraine normally provided internal market information to Gazprom but had ceased doing so at "Christmas". If Ukraine provides this information, Gazprom would be able to determine when Ukraine reserves would run out, giving Gazprom the upper hand in negotiating the RUS-UKR bilateral supply contract. Thus Ukraine is in a difficult situation - it can either fulfill its monitoring agreement to let gas flow to Europe or violate

the agreement to protect its self interest.

¶9. (SBU) The third issue concerns the technical gas to fuel the compressors, which we understand Ukraine is obliged to provide under the terms of the current RUS-UKR transit agreement (which lasts until 2013). Normally, Ukraine would use its own gas, which it receives at a discounted price from Russia. However, since the Russia-Ukraine supply agreement has expired, Ukraine is no longer receiving gas at a discounted price. Thus, it can either use its reserves to fuel the compressors - which no one expects it to do - or use gas destined for Europe. In so doing, Ukraine is subject to charges of stealing and Gazprom can again cease flows (as Putin said "for the good of Europe"). Russia maintains that Ukraine must pay for this gas, but Ukraine refuses to do so at European prices. The Commission has told Gazprom that it must fulfill its supply obligation regardless, and it should work out a sales agreement with Ukraine for this purpose.

¶10. (SBU) Commission officials indicate that Russian technical experts have been by-and-large complying with the agreement (which now appears beneficial to them), while Ukrainian technical experts have been more of a challenge. Ukraine has proposed a 3-month agreement to address technical issues on flows, but Russia has refused to discuss it. The EU monitors will attempt to convene Gazprom and Naftogaz experts to work out the technical issues, identify good entry points, and coordinate action to restore gas flows, but it is not clear yet whether this will be sanctioned. When asked what the U.S. could do to support EU efforts, Hilbrecht asked that the U.S. encourage Ukraine to resume discussions with Russia over domestic pricing. He also asked that U.S. encourage Ukraine to live up to its agreement to allow in Russian monitors.

¶11. (SBU) Comment. We're cognizant allowing the Russian monitors in gives Gazprom access to sensitive internal data that could prejudice Ukraine's negotiating position on a bilateral sales agreement, but Kyiv did sign the agreement and only belatedly seems to have recognized the vulnerability. End Comment.

Silverberg

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